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No. 342

In the Supreme Court of the United States

October Term, 1932

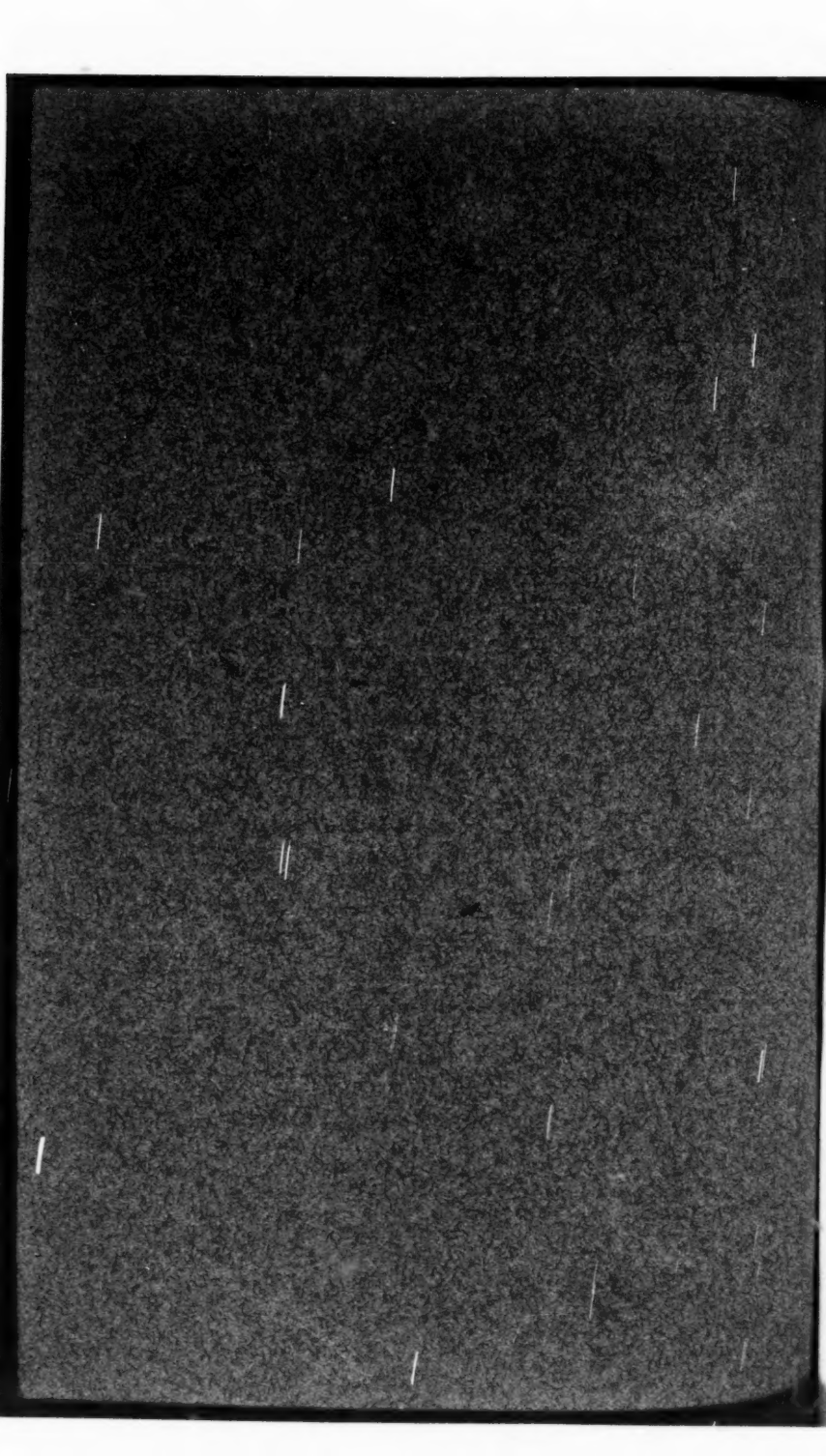
GALEN L. TAFT, COLLECTOR OF INTERNAL REVENUE, PETITIONER,

v.

WESTERN MARYLAND RAILWAY COMPANY, A CORPORATION

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE PETITIONER



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GALEN L. TAIT, COLLECTOR OF INTERNAL REVENUE, petitioner

v.

WESTERN MARYLAND RAILWAY COMPANY, A CORPORATION

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the District Court for the District of Maryland (R. 38–45) is reported in 53 F. (2d) 211. The opinion of the Circuit Court of Appeals for the Fourth Circuit (R. 52–56) is reported in 62 F. (2d) 933.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered January 13, 1933 (R. 57). Petition for a writ of certiorari was filed April 7, 1933, and was

granted April 24, 1933. The jurisdiction of this Court rests upon Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether an earlier decision of the Circuit Court of Appeals for the Fourth Circuit in a proceeding involving other tax years was *res adjudicata* of the issues herein.

2. Whether the discount on bonds sold prior to March 1, 1913, by respondent's predecessors could be amortized by respondent over the life of the bonds and a prorated proportion be deducted annually from taxable income in the years 1920 to 1925, inclusive.

STATUTES AND REGULATIONS INVOLVED

The applicable statutes and regulations are contained in the Appendix, *infra*, pp. 33–34.

STATEMENT

This consolidated cause, a jury being waived, was tried before the District Court upon a stipulation of facts (R. 29) which may be summarized as follows:

The Western Maryland Rail Road Company (hereinafter sometimes called Company No. 1), a corporation of the State of Maryland, sold and issued over the period from October 1902 to December 1908, $42,518,000 first-mortgage 4 per cent bonds at a discount of $3,021,351.67 (R. 30). On March 5, 1908, a receiver was appointed for that company, and, in proceedings brought to foreclose

a second mortgage, its entire property was sold to a reorganization committee representing the holders of bonds secured by the second mortgage (R. 30). Thereafter, the property was sold and conveyed to The Western Maryland Railway Company (hereinafter sometimes called Company No. 2), a new corporation created under the laws of Maryland, for the purpose of acquiring and operating said property (R. 30). As a part of the purchase price of said property The Western Maryland Railway Company assumed the obligation of the first-mortgage bonds which had been issued at a discount (R. 30–31).

In July and August 1911 The Western Maryland Railway Company sold additional bonds in the face amount of $4,115,000 at a total discount of $617,100. These bonds were issued in the name of Western Maryland Rail Road Company, were identical in every way with the first-mortgage bonds theretofore sold at a discount by that company, and were secured by the same mortgage (R. 30).

On February 15, 1917, The Western Maryland Railway Company was consolidated with its subsidiaries, and the property conveyed to respondent, Western Maryland Railway Company (hereinafter sometimes called Company No. 3), in accordance with a consolidation agreement (R. 32). Such of the aforesaid bonds as then remained outstanding were recognized by the respondent (Company No. 3) on its books as its own obligations. However, no part of the discount at which the

bonds were originally sold was brought forward as such or amortized on respondent's books, or amortized in its reports to the Interstate Commerce Commission (R. 35), nor had such discount been amortized on the books of Western Maryland Rail Road Company (Company No. 1) or The Western Maryland Railway Company (Company No. 2) (R. 31).

In the determination of respondent's taxable income for the years 1920 to 1925, inclusive, the Commissioner of Internal Revenue did not allow as a deduction from income any part of the said bond discount (R. 37). In its returns for 1920, 1921, and 1922, the respondent did not claim the right to make such deductions (R. 35–36). The respondent instituted four suits to recover taxes for the years 1920 to 1925, inclusive, two of which named the United States as defendant (for 1920 taxes) and the others of which named the Collector as defendant (for 1920–1925 taxes).

The suits were consolidated in the District Court (R. 17–21). That court gave judgment for the respondent, holding that the judgment in its favor in *Western Maryland Ry. Co.* v. *Commissioner*, 33 F. (2d) 695 (C.C.A. 4th), was *res adjudicata* in the instant case.[1] The Circuit Court of Appeals affirmed the judgment of the District Court (R. 57).

[1] *Western Maryland Ry. Co.* v. *Commissioner*, 33 F. (2d) 695 (C.C.A. 4th), involved a petition for review of a decision of the Board of Tax Appeals. The Board had held that the respondent was not entitled for the years 1918 and 1919 to

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that its previous decision in *Western Maryland Ry. Co.* v. *Commissioner,* 33 F. (2d) 695, was *res adjudicata* of the issues herein.

2. In failing to consider the instant case on the merits.

3. In failing to hold that the respondent was not entitled to the claimed deductions for amortization of discount on bonds sold by other corporations.

4. In affirming the judgment of the District Court.

SUMMARY OF ARGUMENT

Various provisions of the Revenue Acts show that Congress intended that each tax year should be treated as a unit, and that the proceedings in respect of the tax for each year constitute a separate cause of action. Under these statutes the rule of *res adjudicata* or estoppel by judgment should not be applied where different tax years are involved for somewhat the same reasons of policy which induced this Court not to apply the rule in *United States* v. *Stone & Downer Co.,* 274 U.S. 225. Application of the rule of *res adjudicata* to Federal tax cases involving different years would result in inequality and confusion and produce other mischievous consequences. Public policy re-

annual deductions of an amortized portion of the discount on the bonds which had been issued by its predecessors. The decision of the Board was reversed by the Circuit Court of Appeals.

quires that an erroneous decision in one tax year should not be forever perpetuated by the application of the doctrine. If applied here, it would prevent consideration of the true facts which were in part not before the court below when its earlier decision was rendered. Even if otherwise applicable, the doctrine of *res adjudicata* may not apply in such of the present suits as are against the Collector.

Upon the merits, the respondent was not entitled to the deduction of bond discount on bonds sold by its predecessors. The right to deduct bond discount is conferred by Treasury Regulations which confer it only upon the corporation issuing the bonds. The respondent did not issue the bonds and was a new taxable entity. There is no basis for disregarding its corporate entity or for giving it the right of deduction by succession. The assumption of the assets and liabilities of its predecessors did not give it the right to the claimed deduction.

ARGUMENT

I

THE DOCTRINE OF RES ADJUDICATA SHOULD HAVE NO APPLICATION IN SUITS INVOLVING FEDERAL TAXES FOR DIFFERENT YEARS

The court below decided that the question of the respondent's right to amortize and deduct bond discount in its tax returns for the years 1920 to 1925 was *res adjudicata* by reason of its earlier decision in a case involving the right to amortize

and deduct during the tax years 1918 and 1919. *Western Maryland Ry. Co.* v. *Commissioner,* 33 F. (2d) 695 (C.C.A. 4th). We contend that this decision is erroneous and that the judgment in the earlier case was not conclusive of the issues in the instant case.

We believe that the provisions of the Federal Revenue Acts conclusively show that Congress intended not only that each tax year should be treated as a unit (cf. *Burnet* v. *Sanford & Brooks,* 282 U.S. 359; *Burnet* v. *Thompson Oil & Gas Co.,* 283 U.S. 301, 306), but that the proceedings in respect of the tax for each tax year should constitute a separate cause of action and that a judgment as to one tax year should not operate to estop either the Government or the taxpayer from litigating any issue relating to the tax for a subsequent year.

Congress has authorized the Commissioner of Internal Revenue to determine a deficiency for *any year* in which he determines that the tax has been unpaid.[2] The Revenue Acts afford to taxpayers the opportunity to bring suit for the recovery of taxes paid in any year.[3] These statutes disclose the policy of Congress to make the courts available to the Government and taxpayers alike for the pur-

[2] Section 250, Revenue Act of 1921 (c. 136, 42 Stat. 227); Section 274, Revenue Acts of 1924 (c. 234, 43 Stat. 253; U.S.C., Title 26, Sec. 1048) and 1926 (c. 27, 44 Stat. 9; U.S.C.App., Title 26, Sec. 1048).

[3] Section 1318, Revenue Act of 1921 (U.S.C., Title 26, Sec. 156); Section 1014 (a), Revenue Act of 1924 (U.S.C., Title 26, Sec. 156); Section 1113, Revenue Act of 1926 (U.S.C. Sup. VI, Title 26, Sec. 1672).

pose of determining questions arising under the Revenue Acts, without being precluded by litigation which may have been instituted as to other years, thus treating each taxable year separately and giving the parties the benefit for the new taxable period of any recent decisions of the courts.

In harmony with this Congressional policy, the statutes have required that where changes in Treasury Regulations were occasioned by a decision of a court of competent jurisdiction, they should be given retroactive effect.[4] The statutes authorize closing agreements between the taxpayer and the Government to settle the tax liability for any year,[5] and the Board of Tax Appeals has held that such an agreement "bars only the reopening of tax liability for the year covered thereby and in no way estops the petitioner from pleading and proving any fact overlooked in such year but related to the tax of a subsequent year." *W. C. Mitchell Co.* v. *Commissioner*, 27 B.T.A. —.

Congress has likewise legislated specially with respect to certain situations in order to save the Gov-

[4] Section 1314, Revenue Act of 1921; Section 1008 (a), Revenue Act of 1924 (U.S.C., Title 26, Sec. 1251); Section 1108 (a), Revenue Act of 1926 (U.S.C.App., Title 26, Sec. 1251). Compare Section 605, Revenue Act of 1928, 45 Stat. 791, 874 (U.S.C. Sup. V, Title 26, Sec. 1251).

[5] Section 1312, Revenue Act of 1921; Section 1006, Revenue Act of 1924 (U.S.C., Title 26, Sec. 1249); Section 1106 (b), Revenue Act of 1926 (U.S.C.App., Title 26, Sec. 1249; Section 606, Revenue Act of 1928, c. 852, 45 Stat. 791 (U.S.C. Sup. VI, Title 26, Sec. 1660).

ernment's right of resettlement in the event of the favorable outcome of test suits. *Poe* v. *Seaborn,* 282 U.S. 101, 116. The Board of Tax Appeals seems to have positive authority to reexamine the facts with relation to the taxes for other taxable years so far as may be necessary to determine correctly the tax in a different year pending before it. Section 274 (g), Revenue Act of 1926, U.S.C.App., Title 26, Sec. 1049 (b).

A distinction has been drawn between the operation of a judgment where a second action is brought upon the identical cause of action involved in an earlier case and where, although the second action is on a different cause of action, an issue determined in an earlier suit is involved. *Cromwell* v. *County of Sac,* 94 U.S. 351. In the first situation all claims which might have been litigated pass into the judgment and the judgment is *res adjudicata* of the second suit. Where, however, the suit is based upon a different cause of action, the judgment in the first suit operates as an estoppel only as to issues actually decided therein and involved in the second suit.

The statutory scheme referred to above discloses that the subject matter of a tax suit is the tax for the particular year involved and, accordingly, that suit for a particular year involves a different cause of action from a suit for any other year. See *Ford* v. *Commissioner,* 51 F. (2d) 20¢ (C.C.A. 6th), certiorari denied, 284 U.S. 666. Indeed, it is not disputed that the present suits involve causes of ac-

tion different from the proceeding involved in the earlier decision of the court below. The sole question is whether the determination of the issue of the respondent's right to deduct amortized discount on the bonds sold by its predecessors in the earlier decision necessarily constitutes an estoppel by judgment which precludes a reconsideration of the question in this case. In view of the serious consequences which would result from the application of the rule of estoppel by judgment to Federal tax cases involving different tax years, we believe that the statutes should be construed as preventing the application of that rule in Federal tax cases involving different years.

The decision in *United States* v. *Stone & Downer Co.*, 274 U.S. 225, dealing with an analogous problem, indicates the principle which we believe should be applied and some of the considerations which should govern decision in this case. The question there involved was whether a judgment of the Court of Customs Appeals deciding the classification of goods upon their importation under the Tariff Acts, was *res adjudicata*, estopping the Government as to the treatment of another importation of the same kind of goods by the same importer. The Court approved the practice of the Court of Customs Appeals in treating such adjudications as not binding in a subsequent proceeding, and held that the doctrine of *res adjudicata* was not to be applied. The Court observed that application of the doctrine

would result in inequality and discrimination in the administration of the customs laws if a permanently binding effect were to be given in all subsequent cases to an earlier decision, itself possibly contrary to the correct rule, favorable to one importer. Thus, we believe that the Court concluded that the doctrine must give way in the face of compelling considerations of policy. Substantially the same considerations indicate that it should not be applied here.

In tax cases arising under the Federal revenue laws, it is apparent that the application of the doctrine of *res adjudicata* or estoppel by judgment would result in inequality in the administration of the laws and would produce mischievous consequences in the conduct of litigation and in the work of the appellate courts.

For example, if the interpretation of the affiliation statutes by this Court in *Handy & Harman* v. *Burnet,* 284 U.S. 136, is not applicable to all corporations regardless of erroneous but unreversed decisions of lower courts granting affiliation in prior years, discrimination, injustice, and confusion would result. In every situation where the tax liability is a recurrent one founded upon an unchanged status of the taxpayer, a decision as to one tax year, either for or against the Government, would, if deemed a binding adjudication for all subsequent years, create an acutely embarrassing condition both administratively and in terms of the

public revenues. Should final judgments of the lower courts be applied as binding determinations in later years, the interests of the Government could be protected only by bringing to this Court every questionable decision in a Government tax case rendered in the lower courts.[6] Unless all such cases were brought to this Court, decisions of the lower Federal courts, even though later declared to be erroneous and overruled, would create a numerous class of taxpayers privileged in the permanent enjoyment of tax exemptions. For example, in *Barnet* v. *Jergins Trust*, No. 541, October Term, 1932, decided March 13, 1933, it was held by this Court that a lessee of certain municipal property was not immune from Federal income tax upon the profits derived from the leased premises. The lower court, however, had held otherwise. If the matter had not been brought here for review at the time it was, the taxpayer in that case, under the ruling of the court below in the case at bar, would be permanently relieved of income taxation even

[6] Since the amendment of the Judicial Code in 1925, there is a limited right of review in this Court. Following this Court's indication of the character of reasons which would be considered as sufficient to justify granting a writ of certiorari (Rule 38, par. 5), it is only in exceptional cases that the Government petitions for the writ in the absence of conflict of decisions. The Government also refrains from making applications for writs in cases where the record fails to present fully the question at issue or is otherwise defective. The files of the Department of Justice show that it was for the latter reason that no petition was presented in the case now held to constitute a bar.

though, in a case subsequently arising, this Court had held that a taxpayer in like circumstances was not immune.

Nor, under the theory of the decision of the court below, would the injustice invariably fall upon the Government. In *Waller* v. *Commissioner,* 40 F. (2d) 892 (C.C.A. 5th), certiorari denied, 282 U.S. 889, and *Herold* v. *Commissioner,* 42 F. (2d) 942 (C.C.A. 5th), it was held that members of certain partnerships were not entitled to allowances for depletion of their respective interests in oil and gas leases which had been held by the partnership. According to the decision below in the instant case the taxpayers there would be bound for all future years by the decision of the Circuit Court of Appeals. But in *Palmer* v. *Bender,* 287 U.S. 551, it was decided by this Court that a member of the identical partnership was entitled to a depletion allowance with respect to the same interests involved in the *Waller* and *Herold cases.* If the doctrine of *res adjudicata* were applied, the several members of this partnership would in future years be taxed upon different bases and at different rates upon interests of precisely the same scope and incidents. Similarly, in *Burnet* v. *Logan,* 283 U.S. 404, it was held that the annual receipts from a certain contract were to be considered a return of capital and were not taxable as income. A contrary conclusion had been reached with respect to the receipts of another taxpayer under the identi-

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cal contract. *Hitchcock* v. *Commissioner,* 44 F. (2d) 756 (C.C.A. 6th). Upon rehearing the latter decision was reversed on the authority of *Burnet* v. *Logan,* but if the time for rehearing or review had elapsed, and had the rule of *res adjudicata* been applicable, unjust exactions from Hitchcock for years to come would have been legalized by a decision contrary to the holding of this Court.

Where, as here, and in Federal tax cases generally, an erroneous decision as to a taxpayer's liability for a particular year will result in inequality and discrimination,[7] public policy plainly requires that the error should not be perpetuated in years to come, but that the taxpayer's liability in other years should be open to reconsideration in the light of the lessons of experience, the force of better reasoning or a more complete disclosure of the facts. Cf. *O'Brien* v. *Wheelock,* 184 U.S. 450.

The instant case discloses a situation where if the true facts had been presented in the earlier case a contrary result would in all probability have been reached. Certain facts were assumed by the court in the prior suit which the record in

[7] In *Long* v. *Rockwood,* 277 U.S. 142, it was held that a State may not tax the income received by one of its citizens as royalties for the use of patents issued to him by the United States. In *Fox Film Corporation* v. *Doyal,* 286 U.S. 123, *Long* v. *Rockwood* was "definitely overruled." If the ruling of the court below in the instant case is sound, Rockwood would be forever immune from future taxation by Massachusetts on the income from patents issued to him, though the State would be at liberty to tax any other citizen similarly situated.

the present suit shows to be different. This case involves the relationship of three different companies. The greater amount of the bonds involved was issued by Western Maryland Rail Road Company (Company No. 1), and the balance by The Western Maryland Railway Company (Company No. 2). None of the bonds was issued by respondent, Western Maryland Railway Company (Company No. 3). In the earlier case, it was erroneously stipulated that Company No. 1 "may be taken as identical" with Company No. 2, and the Circuit Court of Appeals accordingly treated the case as though the bonds had been issued by Company No. 2 under its own mortgage. The record in the instant case shows the true situation, which is more fully set forth *infra* (footnote 12) (R. 30–31). It shows further that the bond discount in question had not been amortized on the books of either Company No. 1 or Company No. 2, although the Circuit Court of Appeals had assumed the contrary in the earlier decision. Hence, it would seem that the question in this proceeding in so far as it affects the bonds issued by Company No. 1, was not determined in the earlier case; application of the doctrine of estoppel would prevent a consideration of that question in the light of the true facts.

So far as we are aware, it has never been supposed by this Court that the first decision regarding a Federal tax question recurring from year to year with respect to many taxpayers, was forever bind-

ing between the parties to the first adjudication. For instance, in *Old Colony R. Co.* v. *Commissioner*, 284 U.S. 552, the question involved had been previously litigated between the same parties, without barring recourse to this Court in a dispute involving a tax for a subsequent year.

Moreover, where cumulative remedies are given by statute the doctrine of *res adjudicata* is not a bar to a second suit. This rule was applied in *United States* v. *Ness*, 245 U.S. 319, where a suit was brought in a United States District Court under Section 15 of the Naturalization Act to cancel a certificate of naturalization which had been issued in a proceeding under Section 11. It was held that the decision in the first proceeding was not *res adjudicata*, but that the United States, after having entered its appearance in the naturalization court, might file an independent suit to cancel the certificate and urge the very grounds which were overruled by the naturalization court. The basis of the decision was that Congress had authorized both proceedings. That reasoning is equally pertinent here, for Congress has authorized a separate proceeding with respect to each year's tax. See also *Maney* v. *United States*, 278 U.S. 17, 23; *Tutun* v. *United States*, 270 U.S. 568, 580.

It is true that the doctrine of *res adjudicata* has been applied in cases involving State taxation. See *New Orleans* v. *Citizens' Bank*, 167 U.S. 371, but cf. *Keokuk & Western R.R. Co.* v. *Missouri*, 152 U.S. 301, 314. But the principle laid down in the

New Orleans case, we believe, should not be extended to cases like the present; the Court refused to apply it in *United States* v. *Stone & Downer Co., supra,* for reasons closely similar to those we now urge against it.[8] In *New Orleans* v. *Citizens' Bank, supra,* the question was whether a taxpayer was exempt from taxation by virtue of a particular contract made between it and the State. While the power to tax was ultimately at issue, the real dispute concerned the interpretation of a contract of no general application, but peculiar to the taxpayer then involved. Until and unless that contract was changed the intrusion of new issues or changed conditions was extremely unlikely; the interpretation of the contract, while affecting the power of the State to tax, did not have immediate effect upon any other taxpayers, nor by giving it binding effect for the future was one taxpayer relieved from taxation which in the same circumstances others were forced to bear. See *United States* v. *Stone & Downer Co., supra,* p. 237. The decision in that case, limited as it is by *National Bank of Louisville* v. *Stone,* 174 U.S. 432, is readily distinguishable from cases like the present, where

[8] Although it did not rest its decision upon that ground, the Board of Tax Appeals in *Haller* v. *Commissioner,* 26 B.T.A. 395, apparently considered that the doctrine of *res adjudicata* applied to cases involving Federal taxes for different years. In the Court of Appeals of the District of Columbia, where the case is now pending on review (No. 5844), the Government's brief makes no argument in support of the application of the doctrine, and the court has been advised that we are taking a contrary position here.

laws of general application are involved and where numerous taxpayers are similarly situated.

In *Deposit Bank* v. *Frankfort,* 191 U.S. 499, the Court held that a prior adjudication by this Court that there was a contract of exemption from taxation, in favor of a taxpayer, prevented relitigation in a State court of the question whether such a contract existed. While the effect of the decision was to exempt one bank from taxation to which others might be subject, the decision really turned upon the duty of a State court to give effect to a final judgment of this Court. It had been decided, in *Stone* v. *Deposit Bank,* 174 U.S. 800, that the bank had proved an irrevocable contract with the State involving the scope of the latter's power to tax. That decision was based on rulings of the State courts, which were subsequently overruled. When these rulings were overruled in later State decisions and it was sought to subject the bank to taxation, this Court held that such an attempt if successful would impair the obligation of a contract declared to exist by the Federal courts, whose decisions had not been modified or set aside by any court of competent jurisdiction. It is true that the opinion of this Court contains language indicating readiness to adhere to the technical rules of *res adjudicata* even in tax cases, but apparently the true *ratio decidendi* was that the State court had no power to impair the obligations of a contract the validity of which had been adjudicated in the de-

cree of the Federal court. That this was the real nature of the case is evidenced by the dissenting opinion of Chief Justice Fuller, concurred in by Justices Brewer, Brown, and Peckham, which was directed to the proposition that the State court in rendering judgment for taxes in years not involved in the first case before this Court, did not refuse to give the Federal decree such effect as it was entitled to. Our analysis of the case is further supported by the circumstance that in Kentucky, where the case arose, "an adjudication concerning taxes for one year cannot be pleaded as an estoppel in suits in that State involving the taxes of other years." *Deposit Bank* v. *Frankfort, supra,* p. 514. And it is settled, as this Court said in *United States* v. *Stone & Downer Co., supra,* p. 231, that "a judgment not operating as *res judicata* in suits for taxes for another year in the state court will not be an estoppel in a federal court for subsequent years. *Phoenix Fire and Marine Insurance Co.* v. *Tennessee,* 161 U.S. 174; *Covington* v. *First National Bank of Covington,* 198 U.S. 100." Hence the *Deposit Bank case* apparently went off on the validity of the contract which had been previously adjudicated, rather than on the application of the rules of *res adjudicata* to taxes recurring annually. In *Covington* v. *First National Bank, supra,* pp. 108–109, Justice Day, who had delivered the opinion of the Court in *Deposit Bank* v. *Frankfort,* explained that case as follows: "* * * in that case the

court was dealing with the effect to be given to a judgment of a Federal court in which such contract right had been adjudicated, when the Federal judgment was set up in a state court; * * * The case of *Deposit Bank* v. *Frankfort* was only concerned with the effect to be given to a Federal judgment adjudicating a contract right when pleaded in a state court."

Moreover, so far as we are aware, every case but one in which this Court has applied the rules of *res adjudicata* to suits for State taxes for different years, involved a prior determination that a valid contract exempted the citizen from taxation.[9] See *New Orleans* v. *Citizens' Bank, supra; Deposit Bank* v. *Frankfort, supra; Gunter* v. *Atlantic Coast Line R. Co.,* 200 U.S. 273. It may well be

[9] In *Baldwin* v. *Maryland*, 179 U.S. 220, taxes for the years 1893 and 1894 had been found by the Maryland courts to be due from the guardian of the estate of a minor, notwithstanding the contention that they were both non residents and nonresidents were not subject to the tax. In 1895, the taxes for 1893 and 1894 being still unpaid, the State sued the guardian's bondsmen for the taxes for 1893, 1894, and 1895. This Court observed that the taxes for the first two years had already been litigated. The taxes for 1895, it was said, stood on no other footing, and the ruling as to them was "determined by the conclusion in respect to the taxes of 1893 and 1894." There was no discussion of the problem of *res adjudicata* as to tax matters; the Court merely cited a case involving royalties from patents, another involving the location of mining claims, and finally *New Orleans* v. *Citizens' Bank, supra.* The Court declined to pass on the question whether the adjudication of the dispute between the State and the guardian was binding also on the latter's bondsmen.

that where a *contract* is involved, a judgment in a tax suit for one year, holding that there is an exemption from taxation, may have the effect of restraining all future attempts to tax. For there, the thing adjudged is that the citizen has a contract which may not be impaired by any act of the State. If, subsequent to a decision that such a contract exists, a State court may judicially declare its non-existence and consequent non-impairment, the protection intended to be furnished by the Constitution is of small value. As was said in *Berryman* v. *Whitman College,* 222 U.S. 334, 346–347:

> * * * to deny in a case of contract exempting from taxation the right to a decree co-extensive with the power to tax which the contract restrained would be in and of itself an impairment of the contract, since if judicial power was not adequate to control by the thing adjudged the right to a contract exemption and to prevent violations of such right, the power to contract would be of no avail.

We submit that in Federal tax cases the doctrines of *res adjudicata* or estoppel by judgment should be limited to suits on the same cause of action. We believe that no decisions of this Court require extension of the doctrines to suits involving Federal taxes for different years and, therefore, upon different causes of action. The serious consequences of extending the application of the doctrines to such cases are indicated above; refusal to extend them would lead to no burdensome conse-

quences. Experience shows that neither the Government nor the taxpayers are inclined to relitigate questions of fact once decided, although apparently it has not heretofore been supposed that the renewal of litigation for different tax years was prevented by the rules of *res adjudicata*. There is no reason to believe that if the judgment herein is reversed renewals of such litigation would increase.[10] Nor if our contentions are upheld would there seem to be danger of an expanded volume of litigation concerning issues of law or of mixed law and fact previously adjudicated between the same parties as to other tax years.[11] The rule of *stare decisis* renders fruitless repeated appeals to the courts in unmeritorious cases.[10]

No rule of public policy should, by automatic application of the forms in which the rule has become molded by constant repetition, be permitted to dis-

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[10] However, as we have indicated above, affirmance of the judgment below would necessarily increase the burden of the appellate courts since, for its protection, the Government would be compelled to appeal from every doubtful decision and to seek review by certiorari in many cases not now customarily presented to this Court.

[11] Moreover, the authority to make Federal tax assessments is not delegated to local collectors; Federal assessments are made only upon the authority of the Commissioner of Internal Revenue, and there is small likelihood that individual taxpayers will be exposed to harassment where the applicable rules have been judicially settled. It has been held that the remedy of injunction is available if the conduct of taxing officers becomes unduly arbitrary or oppressive. See *Miller* v. *Standard Nut Margarine Co.*, 284 U.S. 498.

serve the public welfare for the promotion of which it was originally devised.

Aside from the foregoing considerations, there is a basis for concluding that even if otherwise applicable the doctrine of *res adjudicata* should not be applied to such of the present suits as were against the Collector. The earlier decision was rendered in a case arising between the Commissioner of Internal Revenue and the respondent. In two of the present suits the United States was defendant, while in the other two the Collector was defendant. If, contrary to our belief, the former judgment was otherwise conclusive, it may be conceded for present purposes that it would be binding in the suits against the United States, since the Commissioner of Internal Revenue acted in the earlier suit in his official capacity as a representative thereof. But the decisions of this Court indicate that for purposes of the application of the doctrine of *res adjudicata* the Commissioner (or the United States) and the Collector are to be regarded as different parties. In *Sage* v. *United States,* 250 U.S. 33, it was held that a former judgment against a Collector was not a bar to a subsequent suit by the United States, even where a tax for a single year was involved. In *Bankers Pocahontas Co.* v. *Burnet,* 287 U.S. 308, it was held that a judgment against a Collector was not *res adjudicata* in a sub-

sequent proceeding involving the Commissioner of Internal Revenue, relating to taxes for different years.

Unless the *Sage* and *Bankers Pocahontas Coal Co.* cases are to be distinguished because they both involved situations where the first suit was against the Collector, they may be applicable here, and, if so, the judgment below was certainly erroneous in the suits involving the Collector. The view that the *Sage* case is distinguishable upon the ground stated was adopted in *Second National Bank of Saginaw* v. *Woodworth,* 54 F. (2d) 672 (E.D. Mich.), and in *Bertelsen* v. *White,* 58 F. (2d) 792 (Mass.). In those cases the first suit was against the United States and the second suit was against the Collector, but they both involved proceedings for the same tax year. In this case the court below has relied on the distinction where the suits involved different tax years. In the *Second National Bank of Saginaw* case, the Treasury Department, acting for the Collector on appeal, has argued that the distinction made by the District Court was correct. Since we know of nothing in the decisions of this Court to suggest that such a distinction exists, we submit the matter for consideration. We do not feel justified in urging that the distinction is nonexistent, in view of the position which the Treasury Department has taken, although that position has not received the approval of the Department of Justice.

II

UPON THE MERITS, THE RESPONDENT WAS NOT ENTITLED TO DEDUCT ANY DISCOUNT ON BONDS SOLD BY ITS PREDECESSORS

As the court below held that its earlier decision (33 F. (2d) 695) was *res adjudicata* of the issues herein, it did not consider or pass upon the merits of the present suits. The question on the merits is whether the respondent is entitled to deduct from gross income, annually, an amount for amortized discount upon the bonds sold by its two predecessors. In the earlier decision the court below held that the respondent was entitled to such deduction, but we believe that that decision was clearly erroneous and that upon the merits the present cases should have been decided in favor of the Government.

The claimed right to deduct discount upon the issuance of bonds by a corporation rests entirely upon Treasury Regulations. Article 544 (3) (a), Regulations 45 (1920 edition), provides in part:

> If bonds are issued by a corporation at a discount the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds.

This regulation was based upon the earlier provisions of Article 15, Regulations 33, and was followed by substantially identical provisions in Article 545 (3) (a), Regulations 62, 65, 69, and Article 68 (3) (a), Regulations 74. Article 563, Regulations 45 (1920 edition), provides in part:

> If it (a corporation) sells its bonds at a discount, the amount of such discount is treated in the same way as interest paid * * *

Similar provisions are contained in Article 563, Regulations 62, 65, 69. The reenactment of the provisions of the 1918 Act, construed in Regulations 45, in the 1924 and 1926 Acts, imports legislative approval of the provisions of the regulations. *Old Colony R. Co.* v. *Commissioner,* 284 U.S. 552; see *Massachusetts Mutual Life Insurance Co.* v. *United States,* No. 322, October Term, 1932, decided February 6, 1933; *Burnet* v. *Guggenheim,* No. 283, October Term, 1932, decided February 6, 1933.

By their plain terms the provisions of the regulations authorize the deduction of amortized bond discount only by the corporation which issues the bonds. The bonds with respect to which the respondent seeks to deduct discount were not issued or sold by respondent, but were issued and sold by its predecessors. Under the regulations, therefore, the respondent had no right to deduct the discount.

In its earlier decision the court below reached the conclusion that the respondent was entitled to deduct amortized bond discount upon the bonds sold by its predecessors upon two grounds: (1) that there was only a technical legal difference between the respondent and its predecessors, which the court should disregard, and accordingly that the respondent was entitled to make the deduction

as if no reorganization had occurred; and (2) that by acquiring the assets and assuming the liabilities of its predecessors the respondent became entitled to deduct the discount. It is to be noted that in the original decision the dissenting judge took the view that the respondent and its predecessors were separate legal entities and that the respondent did not in any way acquire the right to deduct any part of the discount.

In reaching the conclusion in its original decision that the respondent was entitled under the regulations to deduct discount on bonds sold by its predecessors the court below necessarily disregarded the fact that the respondent was an entity separate and distinct from its predecessors. Indeed, the court expressly disregarded that fact and treated it as a technicality which must be brushed aside in an effort to regard substance and not form.

The respondent was formed by a consolidation accomplished under the laws of Maryland and Pennsylvania. (Chap. 553 of the Acts of 1890 of the General Assembly of Maryland, as amended by Chap. 664 of the Acts of 1916, being Article 23, Sec. 218, Bagby's Ann. Code of Maryland; Pennsylvania Acts of March 24, 1865, P.L. 49, and April 10, 1869, P.L. 24.) (R. 32.) The courts in both States hold that the consolidating companies go out of existence and that a new corporation is created. *State, use of Dodson* v. *Balto. & Lehigh R.R. Co.*, 77 Md. 489; *Diggs* v. *Fidelity & Deposit Co.*, 112 Md. 50; *Thom* v. *Baltimore Trust Co.*, 158 Md. 352;

Dalmas v. *Philipsburg & S. Val. R.R. Co.*, 254 Pa. 9. See *Penna. Utilities Co.* v. *Pub. Serv. Com.*, 69 Pa.S.Ct. 612; *York Haven W. & P. Co.* v. *Pub. Serv. Com. et al.*, 287 Pa. 241; *Bwist's Estate*, 297 Pa. 537. There are expressions in some of these cases to the effect that the new entity succeeds to the rights and liabilities of the old companies, but such terms do not embrace the results of selling bonds at a discount, and if they did, obviously State law cannot provide a system of succession to deductions under the Federal Revenue Acts. The crucial fact established by State law is that the respondent is a new entity separate and distinct from its predecessors.[12]

After the recent decisions of this Court in *Dalton* v. *Bowers*, 287 U.S. 404; *Burnet* v. *Clark*,

[12] While we believe that the fact that the respondent is a separate corporate entity makes it unnecessary to examine its corporate structure in relation to that of its predecessors, it is entirely clear that even if that is considered, the difference between the corporations was not merely formal; they differed in substance as well. An examination of the capital structures of the three companies reveals marked differences. Company No. 1 had outstanding:

$15,685,400 of common stock (R. 31).

$42,518,000 of first-mortgage bonds (R. 30).

$10,000,000 of second-mortgage bonds (R. 31).

After the reorganization of 1908–09, Company No. 2 had outstanding:

$21,521,400 of common stock (R. 31–32).

$10,000,000 of preferred stock (R. 31).

$42,518,000 of first-mortgage bonds (R. 30).

The stock of Company No. 2 was distributed as follows:

The holders of the old capital stock upon payment of 40 per cent of its par value received the new common stock in

287 U.S. 410; *Burnet* v. *Commonwealth Improvement Co.*, 287 U.S. 415, and *Planters Cotton Oil Co.* v. *Hopkins*, 286 U.S. 332, no argument is required to show that in its earlier decision the court below erred in disregarding the separate corporate entity of the respondent in order to give it a deduction denied by the regulations. The earlier decision in this respect was based principally upon decisions of this Court in *Southern Pacific Co.* v. *Lowe*, 247 U.S. 330; *Gulf Oil Corporation* v. *Lewellyn*, 248 U.S. 71, and several other cases decided by this Court at about the same time in which, under particular circumstances, separate corporate entities were disregarded. As appears from the decision in *Burnet* v. *Commonwealth Improvement Co., supra*, those cases are not to be regarded as laying down any general rule applicable to tax cases, and, in view of the later decisions of this

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exchange, share for share, to the extent of $15,685,400 (R. 31–32). Holders of the old second-mortgage bonds received the $10,000,000 preferred stock and in addition $836,000 par value of common stock in payment of overdue interest coupons (R. 31). These bondholders were also permitted to purchase $5,000,000 par value of common stock upon the payment of 40 per cent thereof (R. 31). The first-mortgage bonds of Company No. 2 were the obligations of Company No. 1 which had been assumed by Company No. 2 (R. 30). The preferred stock had equal voting rights with the common, and thus it will be seen that the control of the business had passed from the common stockholders of the old company to the second-mortgage bondholders. In addition to the $42,518,000 first-mortgage bonds already outstanding, Company No. 2 thereafter sold $4,115,000 more at a discount of $617,100. These were issued in the name of Company No. 1 and were identical in every way with the bonds of the

Court, we believe that the effort, in the eralier decision of the court below, to disregard form in a search for an intangible substance was clearly unjustified.

It has been held in several cases that new taxable entities succeeding to the assets and liabilities of predecessors do not acquire their right to deductions. See *Athol Manufacturing Co.* v. *Commissioner,* 54 F. (2d) 230 (C.C.A. 1st); *The Maytag Co.* v. *Commissioner,* 17 B.T.A. 182; cf. *Planters Cotton Oil Co.* v. *Hopkins,* 286 U.S. 332; *Woolford Realty Co.* v. *Rose,* 286 U.S. 319. Since the

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same series which had been previously sold by Company No. 1 and were secured by the same mortgage, dated October 1, 1902 (R. 30).

After the reorganization of 1917, Company No. 3, the respondent, had the following outstanding:

$50,000,000 of common stock (R. 32).

$17,760,400 of first preferred stock (R. 32).

$10,000,000 of second preferred stock (R. 32).

$46,633,000 of first-mortgage bonds (R. 30).

This common stock was acquired by exchanging, share for share, the common stock of Company No. 2 (R. 32), which in 1917 had outstanding $49,429,230 of common stock. (Original Exhibit A, p. 14.) The second preferred stock was issued to the holders of preferred stock of Company No. 2 (R. 32). Part of the first preferred stock was issued to the holders of certain secured promissory notes of Company No. 2, which matured in 1915, and which, with accrued interest, equaled the amount of the first preferred stock which was issued (R. 32–33). The remainder of the first preferred stock was subscribed for at par by the stockholders of Company No. 2 (R. 33). The bonds of Company No. 3 consisted of the $42,518,000 issued by Company No. 1, and the additional $4,115,000 issued by Company No. 2, all of which were assumed by Company No. 3. All classes of stock had equal voting rights (R. 32).

petitioner sold no bonds at a discount, it was not entitled through succession to a deduction for a discount incurred by others. When the property of its immediate predecessor was acquired by petitioner, its predecessor would apparently have been entitled to deduct the remaining amortized discount as a loss (*Metropolitan Properties Corporation*, 24 B.T.A. 220); but it did not and could not pass on to respondent its right to the deduction, since the regulations recognized no such process of succession.

We believe that the court below in its earlier decision also erred in concluding that the respondent was entitled to the deduction because it had assumed liabilities and acquired assets of the predecessor corporations. In the earlier case it seems to have been considered that the issuing corporations had amortized the bond discount on their books, but the stipulation in the present cases is to the contrary (R. 31). The respondent assumed the liability on the bonds at their full face value. There seems to be no possible basis for the view that this obligation was in any way affected by the fact that the issuing corporations had received less than the face amount of the bonds because they had been issued at a discount. The respondent was not a party to any loss sustained upon the issuance of the bonds. It would seem that the only way that the respondent could have received any advantage from the action of its predecessors at the time the bonds were issued would have been in connection with the terms

upon which it took over its predecessors' assets. The fact that the bondholders may receive at maturity more than they paid for the bonds in the first instance does not suggest that respondent has suffered a loss because of the original discount. There is nothing to show that the value of mortgaged assets acquired from its predecessors was not, at the date of acquisition, equal to the full face value of the bonds, and, even if they had not been, the respondent took over a definite liability and was not privy to any loss which occurred before it came into existence.

The Board of Tax Appeals has declined to follow the earlier decision of the court below and has held that similar new corporations are not entitled to amortize discount by reason of assuming the liabilities of the issuing corporation. *Missouri Pacific R.R. Co.* v. *Commissioner,* 22 B.T.A. 267; *Southern Railway Co.* v. *Commissioner,* 27 B.T.A. ——.

CONCLUSION

The decision of the court below is erroneous and should be reversed.

Respectfully submitted.

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APPENDIX

Revenue Act of 1918, c. 18, 40 Stat. 1057, 1077:

> SEC. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:
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> * * * * *
>
> (2) All interest paid or accrued within the taxable year on its indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities * * *.

[The same provision appears in Section 234 (a) (2) of the Revenue Acts of 1921 (c. 136, 42 Stat. 227, 254) and 1924 (c. 234, 43 Stat. 253, 283; U.S.C., Title 26, Sec. 986).]

Treasury Department Regulations 45 (1920 Edition):

> ART. 544. *Sale and retirement of corporate bonds.*—* * *.
>
> * * * * *
>
> (3) (a) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. (b) If thereafter the corporation purchases and retires any of such bonds at a price in excess of the issuing price plus any amount of discount already deducted, the excess of the purchase price over the issuing price plus any amount of discount already deducted (or over the face value minus any

amount of discount not yet deducted) is a deductible expense for the taxable year. * * *.

ART. 563. *Sale of capital stock, bonds, and capital assets.*—* * *. If it sells its bonds at a discount, the amount of such discount is treated in the same way as interest paid * * *.

[The same provisions appear in Article 545 (a) (3) and Article 563 of Treasury Department Regulations 62 and 65.]

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